INVESTOR'S BUSINESS DAILY®

FRIDAY, JANUARY 8, 2016

MUTUAL FUNDS

This Top Mutual Fund Manager Seeks Stocks With Sharp Elbows

BY PAUL KATZEFF
FOR INVESTOR'S BUSINESS DAILY

Dennis Lynch's group at Morgan Stanley looks for innovations that can power leading stocks in the future.

For Dennis Lynch, investing is a family affair. The 45-year-old lead manager of $3.5 billion Morgan Stanley Growth is following in the footsteps of his father, who was a money manager and co-founder of Lynch & Mayer, starting in the 1970s.

The elder Lynch (also named Dennis) can be proud. Morgan Stanley Growth was the 25th-best-performing U.S. diversified stock fund in 2015. It outperformed 95% of its peer mutual funds tracked by Morningstar Inc. over the past five years.

And with a 9.4% gain in the fourth quarter that topped 97% of his direct rivals, Lynch was again among the top-performing mutual fund managers.

With Lynch at the helm since mid-2004, the fund has focused on its managers' best ideas rather than on overdiversifying. It has aimed for securities in the stock market that benefit from competitive advantages such as a network effect among site visitors and from a steady flow of subscription-based revenues.

And in an industry that employs battalions of analysts who are experts at diving into the details of earnings reports, a key member of Lynch's team is a futurist whose job is to spot emerging investment trends years before they generate revenues and profits.

Lynch talked with IBD about his investment approach from his office in Manhattan.

IBD: Dennis, your fund has outperformed in 2015 and long-term. But in 2012 and 2014 it was middle of the pack. What went against the fund's approach in those years?

Lynch: We try to add value through stock picking and identifying what we think are mispriced or undervalued companies, companies that are undervalued because investors don't understand the quality of their business or how they can grow over time.

Along the way, there can be periods when specific ideas are not working or the market is not in agreement with our ideas. We had a challenging period in 2012. In the back part of the year we did poorly, given a large allocation to **Facebook**FB. It came public with a lot of public enthusiasm, then went through a vicious and challenging period when the stock price more than halved.

We actually added to our position during that challenging period, then later on we benefited as the stock price rebounded.

Generally, when we have ups and downs relative to the market or peer groups, sometimes it's because we're going through a period when the market thinks we're wrong. And we also make mistakes from time to time.

IBD: Your concentrated portfolio is the flip side of your long-term approach, right?

Lynch: Yes. Why we do well in any given year reflects decisions made in previous years rather than anything we do in the current year.

Amazon.comAMZN is a company we've owned continuously for roughly 13 years. The reasons we got involved were a combination of the online advantages that made them tough to beat. They offer inventory that they don't necessarily possess themselves, but which they have access to.

At the same time, they've slowly built a very large logistical infrastructure in the physical world.

And they target increasingly technology through their Amazon Web Services.

IBD: Is there anything that could disrupt a juggernaut like Facebook?

Lynch: You don't have to worry that another social network will get bigger. That's highly unlikely.

But is there something out there that can take people's attention away, like virtual reality or some other technology that still in its early stages now?

In the absence of something like that, it's unlikely that Facebook's network effect will be challenged anytime soon.

IBD: **LinkedIn**'sLNKD third-quarter profit jumped 50%, a nice rebound from Q2. This is another network-effect play, isn't it?

Dennis Lynch likes stocks with competitive moats and recurring revenues, like Salesforce.com.

Lynch: Both holdings have strong network effects of users connected to each other.

Both have users who cross-connect. It's hard to displace them. Even though both have that at their core, they make money in different ways. So we're not exposed to the same end markets or even the same spending patterns.

Earlier in the year, LinkedIn made changes to its workforce that surprised people. But each quarter, results have seen the fruits of LinkedIn's longer-term thinking.

IBD: The key to **Monster Beverage**MNST is how their deal with **Coke**KO gives them a shot at foreign expansion, right?

Lynch: With Coca Cola becoming a substantial owner, it opens opportunities for distribution to become more efficient in the U.S. and increases chances of capturing more global share. They've had less success outside the U.S.

IBD: Is **Salesforce.com**CRM one of those subscription-revenue companies you like?

Lynch: They provide customer relationship management services that in the past were sold on a high license-fee basis. They had a novel approach of offering those services in a subscription format rather than requiring large upfront fees, which can be costly.

It gives customers the ability to benefit from upgrades to the whole system rather than having to buy a new version of the software for each upgrade cycle.

As a result, they built a high recurring-revenue business. On an annual basis, revenue renewal is over 90%. So that gives their revenue a lot of visibility. They are figuring out how to meet other important needs for large organizations. They're expanding into marketing.

IBD: Why has **Athenahealth**'sATHN share price been choppy recently?

Lynch: Athenahealth is the dominant provider for doctors to get reimbursed by insurers.

And the way their system works, every doctor can learn (about methods for improving insurance reimbursements) from the experience of other doctors on the platform.

Once Athena figures out how to apply new rules for one doctor, all doctors benefit.

So it's hard for a doctor not to join the network. This is an inherent network effect. But their penetration is still less than 10% of the overall doctor market, so they've got a lot of room for growth.

And they've diversified into electronic health records. Once you get a lot of doctors to join, you can provide other services, which draws in more doctors.

IBD: After a rough patch, **Intuitive Surgical**'sISRG earnings-per-share growth is accelerating again. Is this improvement for real?

Lynch: That rough period was when they were transitioning from a first-generation platform to the next generation.

And it's a razor-and-razor-blades model. There are a lot of consumables that need to be reordered each time.

So it's a high recurring revenue model. It continues to take share.

When a company has an upgrade cycle, customers wonder if they should order the old system or the new one. Sales can slow. It happened a couple of years ago. Now things are heading back in the right direction.

IBD: Dennis, how does your team differ from its rivals?

Lynch: One thing I try to emphasize when I talk with people who are thinking about whether to put money in the fund is what skin in the game do people running a product have?

Here, we're not going to do well every quarter or every 12 months. There can be periods when things go badly, but through Morgan Stanley's deferred compensation program, the vast majority of team pay is deferred, and most goes into our products.

We have significant personal exposure through co-ownership with our clients in the products we make for them.

IBD: Tell me about the person on your team whose job is to scout ahead for emerging trends or disruptive new technologies.

Lynch: Yes, in addition to our expert work, meetings with companies, looking at financial statements — those conventional activities — we've dedicated one person to research topics that have the potential to be disruptive in industries or sectors.

IBD: What is your change researcher looking at these days?

Lynch: More recently, he's been focused on Bitcoin and virtual reality. These are potentially powerful emerging themes and disruptive trends.

IBD: Who is your disruptor expert?

Lynch: Stan Delaney.

IBD: How do you and the five other managers on this fund — David Cohen, Sam Chainani, Alexander Norton, Jason Yeung and Armistead Nash — divide your workload? Is each manager responsible for different industrial sectors, for example?

Lynch: I act as a generalist. Outside of me, everyone has a sector and industry expertise. Sam follows the Internet and financials. David follows consumer, which sounds like one industry but is really multidimensional. Jason follows health care and some consumer staples. Armistead follows business services and software. Alex does technology — we think of technology differently than the Internet. Companies use the Internet to create. They are not selling semiconductors or software. Alex focuses on those kinds of business models and things like industrials.

My dad managed large- and midcap growth stocks, starting in the 1970s in a time when managers tended to be generalists. Today people tend to be experts in a category but lacking the perspective of knowing multiple categories and being able to compare. We believe we benefit from taking the generalist approach, and we can leverage the experts.

(#88282) Copyright 2016 by Investor's Business Daily, Inc. Reprinted with permission. To subscribe to Investor's Business Daily, please call (800) 831-2525 or visit us online at Investors.com.
For additional information about reprints or permissions to use Investor's Business Daily content, please visit IBDreprints.com or contact PARS International Corp. at (212) 221-9595.

The opinions are those of *Investor's Business Daily* and Dennis Lynch as of the date presented and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes. The material does not purport to address the financial objectives, situation or specific needs of any individual reader. The use of this article is not a solicitation, or an offer to buy or sell any security or investment product. Moreover, the opinions expressed in this article are not necessarily those of Morgan Stanley or its employees.

No representation or warranty can be given with respect to the accuracy or completeness of the performance and securities information. **Past performance is no guarantee of future results.**

MSIF Growth Portfolio (Class I share) was the 24th best performing fund in the Large Growth category for 2015, as opposed to the 25th reference in the second paragraph.

Please refer to the accompanying Fact Card for the most recent standardized performance and risk disclosures.

Morgan Stanley Investment Management (MSIM) is the asset management division of Morgan Stanley.

© 2016 Morgan Stanley. Morgan Stanley Distribution, Inc.

1395155 Exp. 1/31/2017 Litlink: IBDLYNCH

Morgan Stanley Investment Management

CLASS A: MSEGX • CLASS C: MSGUX • CLASS I: MSEQX • CLASS IS: MGRPX   WWW.MORGANSTANLEY.COM/IM

Morgan Stanley Institutional Fund Growth Portfolio

4Q15 FACTSHEET

Investment Approach

We seek high-quality established companies with sustainable competitive advantages, strong free-cash-flow yields and favorable returns on invested capital trends. We focus on long-term growth rather than short-term events, with our stock selection informed by rigorous fundamental analysis.

Objective

Seeks long-term capital appreciation by investing primarily in growth-oriented equity securities of large capitalization companies.

Lipper Category

Large-Cap Growth

Morningstar Category

Large Growth

Investment Team

	Joined Firm	Years of Investment Experience
Dennis Lynch, Managing Director	1998	22
David Cohen, Managing Director	1993	28
Sam Chainani, Managing Director	1996	20
Alexander Norton, Executive Director	2000	21
Jason Yeung, Managing Director	2002	19
Armistead Nash, Managing Director	2002	16

Investment Performance - Class I (% net of fees)

% Average Annual Total Returns	1 Year	3 Year	5 Year	10 Year	Inception†
Fund	11.91	20.96	14.70	9.64	10.42
Russell 1000 Growth Index[1]	5.67	16.83	13.53	8.53	8.64
Lipper Category Average	5.26	16.17	12.26	7.54	–
Morningstar Category Average	3.60	15.27	11.70	7.33	–

% Calendar Year Returns	4Q15	YTD	2015	2014	2013	2012	2011
Fund	9.40	11.91	11.91	6.42	48.60	15.66	(3.01)
Russell 1000 Growth Index	7.32	5.67	5.67	13.05	33.48	15.26	2.64
Lipper Category Average	7.51	5.26	5.26	10.49	34.19	15.61	(1.51)
Morningstar Category Average	6.73	3.60	3.60	10.00	33.92	15.34	(2.46)

Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown. For the most recent month-end performance figures, please visit morganstanley.com/im or call 1-800-548-7786. Investment returns and principal value will fluctuate and fund shares, when redeemed, may be worth more or less than their original cost.

† **Inception returns reflect the inception date of the fund.**

Performance and fund information is as of December 31, 2015, unless otherwise noted. Returns are net of fees and assume the reinvestment of all dividends and income. Returns for less than one year are cumulative (not annualized). Performance of other share classes will vary.

Please keep in mind that double-digit returns are highly unusual and cannot be sustained. Investors should also be aware that these returns were primarily achieved during favorable market conditions.

Expense Ratios	Symbol	Cusip	Gross (%)	Net (%)
Class A	MSEGX	61744J564	0.83	0.83
Class C	MSGUX	61760X414	1.54	1.54
Class I	MSEQX	61744J861	0.70	0.70
Class IS	MGRPX	61760X711	0.55	0.55

Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund's current prospectus (unless otherwise noted in the applicable prospectus) or until such time as the fund's Board of Directors acts to discontinue all or a portion of such waivers and/or reimbursements. Absent such waivers and/or reimbursements, returns would have been lower. Expenses are based on the fund's current prospectus. The minimum initial investment is $5,000,000 for Class I shares.

Morningstar Overall Rating

Class I shares

★★★★

Out of 1542 Funds. Based on Risk Adjusted Return.

Class I Shares Fund ratings out of 5 Stars: 3 Yrs. 5 Stars; 5 Yrs. 4 Stars; 10 Yrs. 4 Stars.

Morningstar Rankings - Class I Large Growth Category

	Percentile	Rank/ Total in Category
1 Year	2	24/1681
3 Year	1	7/1542
5 Year	5	60/1326
10 Year	5	46/933

Source: Morningstar, Inc. Rankings are based on total returns, are historical and do not guarantee future results.

Fund Facts

Inception date	April 02, 1991
Team inception date	August 05, 2004
Total net assets ($MM)	$ 3,629
Benchmark	Russell 1000 Growth Index
Distribution frequency	At least annually

Portfolio Characteristics

	Fund
Number of holdings	38
Return on capital (%)	10.54
5 year EPS growth (%)	25.25
Sales growth (%)	25.13
Weighted median market capitalization ($B)	52.06
D/E weighted median (%)	42.15
Turnover (%)*	44

Risk/Return Statistics (3 Year)

	Fund
Active share (%)	81.25
Alpha (%)	4.13
Beta (vs. benchmark)	1.03
Information ratio	0.57
R squared	0.70
Sharpe ratio	1.57
Standard deviation (%)	13.33
Tracking error (%)	7.30

Sector Allocation (% of Total Net Assets)

	Fund
Information Technology	42.36
Consumer Discretionary	26.62
Health Care	14.25
Consumer Staples	8.97
Financials	3.27
Industrials	0.49
Cash	3.93

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Top Holdings (% of Total Net Assets)

	Fund
Amazon.com, Inc.	9.29
Facebook, Inc.	8.17
Apple, Inc.	5.65
Alphabet, Inc.	4.92
Illumina, Inc.	4.91
MasterCard, Inc.	4.55
Tesla Motors, Inc.	4.10
LinkedIn Corp.	4.04
Intuitive Surgical, Inc.	3.90
Salesforce.com, Inc.	3.44
Total	**52.97**

Past performance is not indicative of future results. Subject to change daily. Fund information is provided for informational purposes only and should not be deemed as a recommendation to buy or sell any security or securities in the sectors presented.

PORTFOLIO CHARACTERISTICS DEFINITIONS

Return on capital is a measure of a company's efficiency at allocating the capital under its control to profitable investments, calculated by dividing net income minus dividends by total capital. **Earnings per share (EPS) growth** is the weighted average of earnings per share growth for all securities in the portfolio projected for the past five fiscal years. Earnings per share for a company is defined as total earnings divided by shares outstanding. **Weighted median market capitalization** is the point at which half of the market value of a portfolio is invested in stocks with a greater market cap, and consequently the other half is invested in stocks with a lower market cap. **Debt/equity (D/E)** is a measure of a company's financial leverage calculated by dividing its total liabilities by stockholders' equity. **Sales growth** is the increase in sales over a specific period of time, often but not necessarily annually.

RISK/RETURN DEFINITIONS

Active share is the fraction of the portfolio or fund that is invested differently than its benchmark as of the last day of the reporting period. A portfolio with a high degree of Active share does not assure a fund's relative outperformance. **Alpha** is the excess return or value added (positive or negative) of the portfolio's return relative to the return of the benchmark. **Beta** is a measure of the relative volatility of a security or portfolio to the market's upward or downward movements. A beta greater than 1.0 identifies an issue or fund that will move more than the market, while a beta less than 1.0 identifies an issue or fund that will move less than the market. The Beta of the Market is always equal to 1. **Information ratio** is the portfolio's alpha or excess return per unit of risk, as measured by tracking error, versus the portfolio's benchmark. **R squared** measures how well an investment's returns correlate to an index. An R squared of 1.00 means the portfolio performance is 100% correlated to the index's, whereas a low r-squared means that the portfolio performance is less correlated to the index's. **Sharpe ratio** is a risk-adjusted measure calculated as the ratio of excess return to standard deviation. The Sharpe ratio determines reward per unit of risk. The higher the Sharpe ratio, the better the historical risk-adjusted performance. **Standard deviation** measures how widely individual performance returns, within a performance series, are dispersed from the average or mean value. **Tracking error** is the amount by which the performance of the portfolio differs from that of the benchmark.

RISK CONSIDERATIONS

There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and that the value of Portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed countries. **Privately placed and restricted securities** may be subject to resale restrictions as well as a lack of publicly available information, which will increase their illiquidity and could adversely affect the ability to value and sell them (liquidity risk). **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk).

Morningstar

Rankings and ratings as of December 31, 2015. **Rankings:** The percentile rankings are based on the average annual total returns for the periods stated and do not include any sales charges, but do include reinvestment of dividends and capital gains and Rule 12b-1 fees. If they had been, total returns would be lower. **Ratings:** Morningstar, Inc. is an independent publisher of mutual fund research and ratings. Ratings reflect a fund's risk-adjusted 3-, 5-, and 10-year total returns, including any sales charge. A Fund is rated against all other funds in its category. Overall Rating for a fund is derived from a weighted average of the ratings for the time periods indicated. 5 stars are assigned to the top 10%; 4 stars to the next 22.5%; 3 stars to the next 35%; 2 stars to the next 22.5%; and 1 star to the bottom 10%. Morningstar only rates funds with at least a 3-year history.

Source: Morningstar. Morningstar counts each share class as a separate fund for purposes of its ranking and ratings calculations. Morningstar compares mutual funds within a universe of funds with similar investment objectives, including dividend reinvestment. **Past performance is no guarantee of future results.** Morningstar rankings and ratings may vary for other share classes. **© 2016 Morningstar, Inc. All rights reserved.** The information contained herein: (1) is proprietary to Morningstar and/ or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

OTHER CONSIDERATIONS

[1] The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

* Turnover is sourced from the fund's current prospectus.

Please consider the investment objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Investment Management (MSIM) is the asset management division of Morgan Stanley.

© 2016 Morgan Stanley. Morgan Stanley Distribution, Inc.